No. 11051

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SECURITY-FIRST NATIONAL BANK OF LOS ANGELES, a national banking association,

Appellant,

vs.

UNITED STATES OF AMERICA and H. F. METCALF, Trustee in Bankruptcy for the Estate of F. P. Newport Corporation, Ltd., a corporation, bankrupt,

Appellees.

APPELLANT'S OPENING BRIEF.

W. C. SHELTON and
GEORGE W. BURCH, JR.,
923 Subway Terminal Building, Los Angeles 13,
Attorneys for Appellant.

The Myers Legal Press, Los Angeles. Phone MUtual 4961.

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Statement of Pleadings and Facts Disclosing Jurisdiction of United States District and United States Circuit Court of Appeals.

This is an appeal from an order of the United States District Court for the Southern District of California, Central Division, Honorable Paul J. McCormick, Judge, entered February 6, 1945, in C. O. Book 30, page 632, confirming and approving an order of Ernest R. Utley, Referee in Bankruptcy in the Matter of F. P. Newport Corporation, Ltd. a bankrupt, directing the payment of 1938 and 1939 Federal Income Taxes incurred by the Trustee in Bankruptcy, H. F. Metcalf, in conducting the business of said Bankrupt, out of rents, issues and profits

hypothecated to Security-First National Bank of Los Angeles as security for the payment of the indebtedness due it from said bankrupt.

The petition of the United States Government [Tr. p. 81] alleged that the Trustee in Bankruptcy, H. F. Metcalf, in the matter of F. P. Newport Corporation, Ltd., a bankrupt, had failed, neglected and refused to pay Federal income taxes found to be incurred by him for the years 1938 and 1939; that petitioner was informed and believed that Security-First National Bank of Los Angeles claimed an interest in and the right to receive all available funds in the above entitled bankrupt estate. Petitioner prayed that said Trustee in Bankruptcy and said Bank be ordered to show cause why the Trustee in Bankruptcy should not be ordered to pay said Federal income taxes together with interest thereon out of funds in his hands.

Security-First National Bank of Los Angeles, the appellant herein, answered said Petition [Tr. p. 83] admitting it claimed an interest in and a right to collect all of the available funds in said bankrupt estate and denied that the United States Government or any one other than said bank had any lien or interest in said funds or was entitled to receive all or any portion thereof. Said bank prayed that the United States be denied the relief prayed for in its petition but that the court decree that the bank has a first and prior lien on all such property and the rents, issues and profits derived therefrom as security for the payment of its indebtedness due by said bankrupt; that it decree that said trustee in bankruptcy is in possession of said real

property, oil royalties, rents, issues and profits from said real property for and on behalf Security-First National Bank of Los Angeles; that the court order the trustee in bankruptcy to continue to disburse to said bank the oil royalties and other rents, issues, and profits free and clear of any claim of United States or of the claim of the Trustee for expenses of administration. This answer was filed October 13, 1943. The trustee in bankruptcy in said matter answered the petition [Tr. p. 95] alleging that all available funds out of which the claim for Federal income taxes could be paid were claimed to be subject to a first and prior lien by said bank and that the bank claimed that the United States Government could not have its claim for income taxes paid out of the oil and gas royalties referred to in said answer either in whole or in part; that said income taxes were not entitled to priority over any other expense of administration and that if the government was entitled to have its claim for taxes paid out of said royalties, rents, issues and profits, then the other expense of administration should be paid out of the same funds on equal parity with the said claim. The trustee in bankruptcy prayed that the court determine whether or not the expenses of administration, including the claim for income taxes due the United Sates of America are payable out of said oil royalties and for general relief.

The jurisdiction of the trial court and of this court derives from U. S. Code, Title 11, Chapter 2, Section 11 and Chapter 4, Section 47. Said Sections are found in Sections 2 and 24 of the Bankruptcy Act.

Statement of Case.

Under date of March 1, 1930, the bankrupt, F. P. Newport Corporation, Ltd., executed and delivered to Security-First National Bank of Los Angeles its promissory note for $760,000, evidencing an indebtedness then due the bank in said sum [Tr. p. 3]. As security therefor the bankrupt conveyed to said bank, in trust with power of sale, a large number of parcels of real property situated in various locations in Los Angeles County. On even date with said note the said bank, as trustee, and the said bankrupt, as Trustor Beneficiary, executed a Declaration of Trust by the terms of which the bank declared that it held the said property as trustee with power of sale as security for the payment of said indebtedness, and any other indebtedness secured thereby, and to collect the proceeds, and avails, rents issues and profits of the trust estate and disburse the same in accordance with the terms and conditions of said Trust Declaration [Tr. p. 2].

This Trust was then known as Trust No. 70401 [Tr. p. 2]. It was subsequently and, at all times involved herein, known as Trust No. D 7224 [Tr. p. 101].

Parcel 4 of the property originally conveyed to the Trustee was the beneficial interest in Trust P 1512 of Title Guarantee & Trust Co., the corpus of which was composed of approximately nine acres of land on Channel No. 3 of the Long Beach Harbor [Tr. pp. 29-30]. This property, after the title thereto had been finally and successfully litigated in favor of the bankrupt, and after other claims had been compromised and paid off, from advances made by Security-First National Bank of Los Angeles to the Trustee in Bankruptcy under court order, was conveyed to Security-First National Bank of Los Angeles by Title Guarantee & Trust Company and became a part of the

corpus of said Trust No. D 7224 subject to the terms of said Declaration of Trust and the contract entered into modifying and amending the same [Tr. p. 112 and p. 170].

In 1935, said indebtedness then being in excess of one million dollars, the bank commenced foreclosure proceedings, the sale being set for the latter part of March.

On or about March 27, 1935, an involuntary Petition in Bankruptcy against F. P. Newport Corporation, Ltd., was filed in the United States District Court and H. F. Metcalf was appointed Receiver in Bankruptcy for said alleged Bankrupt. The said bank was, on said date, enjoined from foreclosing the security held by it under the terms of said Declaration of Trust [Tr. p. 102, p. 165].

This injunction was continued from time to time over the opposition of said bank until the Contract dated January 12, 1937 was approved by the District Court on January 12, 1937, and F. P. Newport Corporation, Ltd., was adjudicated a Bankrupt [Tr. p. 165]. During this time and up to February 1, 1937, the bank had advanced $107,-768.60 for taxes, assessments and carrying charges on the trust properties [Tr. p. 165]. As of the date of said contract, January 12, 1937, the agreed debt was $1,351,727.38 [Tr. p. 101].

Prior to January 12, 1937, the Receiver in Bankruptcy, the Bank and the F. P. Newport Corporation Ltd., the alleged bankrupt held "extensive negotiations for the purpose of devising a method of liquidation of the properties held by the bank as security" [Tr. p. 168]. These negotiations resulted in a contract dated January 12, 1937, which permitted an orderly liquidation of security held by the bank [Tr. p. 168].

This agreement provided for the adjudication of the alleged bankrupt as a bankrupt, the appointment of a

trustee in bankruptcy, and the submission of the contract to the bankruptcy court for its approval, and, if approved, for the liquidation of the properties and the payment of the bank's indebtedness promptly in certain installments [Tr. pp. 100 to 115].

The District Court approved the contract and on the same date, January 12, 1937, that F. P. Newport Corporation, Ltd., was adjudicated a bankrupt. Thereafter H. F. Metcalf the former Receiver, was appointed trustee, for the creditors, and petitioned the court for approval of the contract. The Referee approved the contract after a supplemental agreement dated August 31, 1937, was executed by the parties [Tr. pp. 118 to 131]. After a review was taken from Referee Utley's Order of Approval, the said contract, after two modifications suggested by Judge McCormick were stipulated to by all parties, was finally approved by Judge McCormick on November 5, 1937 [Tr. p. 181].

On appeal to this Circuit Court of Appeals, the order of Judge McCormick was in all respects affirmed [Tr. p. 182] *certiorari* was denied by the United States Supreme Court. By this judgment the bank's security was declared to be a trust deed, legal and valid in all respects and the contract of January 12, 1937 as supplemented and modified and then approved by Judge McCormick to be fully ratified and approved, and the Order of Judge McCormick approving the contract was affirmed.

By the terms of this contract, as supplemented and modified, the income, rents, issues and profits from the trust estate of Trust D 7224 held by the bank as security were expressly impressed with the lien of said trust deed and were expressly sequestered for payment in full to the bank by the trustee in bankruptcy to be applied on its indebted-

ness. The income, royalties, rents, issues and profits were expressly declared to be no part of the general assets of the bankrupt estate. They were expressly earmarked for application on the bank's indebtedness and were to be kept in a separate account while in the hands of the trustee in bankruptcy and be paid *in full* to the bank forthwith [Tr. p. 121 and p. 130].

Under date of January 14, 1938, an Oil and Gas Lease was entered into with Universal Consolidated Oil Co. a California corporation, by the said bank, the trustee in bankruptcy, and the bankrupt, under order of the bankruptcy court, on the 9 acre parcel situated in the Long Beach Harbor area [Tr. p. 132 and p. 237]. Oil and gas were discovered by the lessee that year and substantial quantities of oil and gas were produced therefrom during the years 1938 and 1939.

All bonuses and royalties from said lease were, pursuant to said contract, placed in a special oil account by the Trustee in Bankruptcy. Thereafter all said bonuses and royalties for the years 1938 and 1939, were paid over to the bank pursuant to the said sequestration agreement. For said years the bank received $451,851.00 of which $97,-665.88 was applied on interest and $59,665.88 on taxes assessed against the trust property [Tr. pp. 237-238].

Subsequently thereto the Internal Revenue Department of the United States Government assessed income taxes for the years 1938-1939 in the sum of $19,363.65 against the Trustee in Bankruptcy on the theory that the said trustee was not liquidating the bankrupt estate but was

conducting the business of the bankrupt. This assessment of taxes was resisted by the Trustee in Bankruptcy. The bank was not a party to these proceedings.

This Circuit Court of Appeals reversed Judge McCormicks' order disallowing the government's claim for said taxes, whereupon on April 8, 1945, Judge McCormick entered his order pursuant to mandate of said Circuit Court, adjudging that said Trustee in Bankruptcy was indebted to the United States Government in the sum of $19,363.65 for 1938 and 1939 income taxes.

Said taxes remaining unpaid, the United States Government filed the instant Petition for its Order to Show Cause directed to the Trustee in Bankruptcy and said bank, ordering them to show cause why an order should not be made directing said taxes to be paid out of any funds held by the trustee.

The trustee answered, alleging that the bank claimed all of said funds as belonging to it under its deed of trust and the agreement of January 12, 1937, as modified and amended and it could not pay said indebtedness from these funds, most of them arising from royalties rents, issues and profits, until the court passed on the question of the bank's claim to have the same paid over in full to it.

The bank answered, claiming all the funds as being impressed with its lien and as being sequestered funds held by the trustee for the payment on its debt.

The District Court held that said funds were available to the Trustee to pay said income taxes and ordered the Trustee to pay said taxes [Tr. pp. 358 and 359]. The bank takes its appeal from the said Order.

Assignment of Errors.

Upon this Appeal appellant urges:

I.

The District Court erred in holding that the income tax for the calendar years 1938 and 1939 was the result of income, the full benefit and enjoyment of which was had by the Secruity-First National Bank of Los Angeles.

II.

The District Court erred in holding that the properties, the record title to which is held by the bank under its Trust D 7224, as security for the obligation owing to said bank by the bankrupt, have been administered by the Trustee in Bankruptcy by and with the consent and approval of the said bank and for the benefit of the said bank.

III.

The District Court erred in holding that the income taxes for the years 1938 and 1939 are incidental to said administration and a necessary part of the expense of operating, preserving and liquidating the properties and proceeds thereof.

IV.

The District Court erred in finding that Security-First National Bank of Los Angeles had the full benefit of the income which resulted in the assessment of said taxes and should, therefore, pay the said taxes out of that income.

V.

The District Court erred in finding that by the provisions of the agreement of January 12, 1937, as supplemented and modified, the oil and gas royalties can be used to pay said income taxes.

VI.

The District Court erred in holding that the claim of the United States Government for said income taxes should be paid out of the special accounts of said trustee in bankruptcy, and that if the funds now deposited in Special Accounts are insufficient to pay said taxes that they should pay any deficiency out of oil and gas royalties when and as received from Universal Consolidated Oil Co.

VII.

The District Court erred in holding that the Referee in Bankruptcy did not err in his order of June 6, 1944, directing said Trustee in Bankruptcy to pay said income taxes out of the oil royalties, rents, issues and profits received by him and deposited in special accounts pursuant to the agreement of January 12, 1937.

VIII.

The District Court erred in affirming the Order of the Referee in Bankruptcy dated June 6, 1944, directing the payment of taxes out of funds impressed with a first and prior lien in favor of said bank and sequestered by the agreement of January 12, 1937 as modified and amended for the payment of said bank's indebtedness.

ARGUMENT.

The Bank's Lien Is No Part of the Bankrupt Estate and Is Not Chargeable With the General Costs of Administration of the Bankrupt's Estate.

The Bankruptcy Act defines the bankrupt estate as follows:

> "The bankrupt's estate consists of property of a bankrupt diminished by valid liens."
>
> *In re Tressler,* 20 F. (2d) 663.

This Honorable Court in the case of

In re Williams, 156 Fed. 934 at 939 (9th Cir.),

said:

> "They" (the proceeds from property subject to a valid lien) "are not chargeable with the general costs of the administration of the bankrupt's estate, such as the services of a receiver in carrying on the business of the bankrupt, the expenses and losses of such business, the fees of the trustee or of his attorney. If so, the valid lien upon the estate of a bankrupt which the Bankruptcy Act expressly declares shall be unaffected by any of its provisions might very readily be destroyed, as it would unquestionably be, should such costs equal or exceed the proceeds in cases like the present, where the aggregate amount of the valid lien exceeds the proceeds of the entire estate of the bankrupt.
>
> In line with this ruling are the cases of Stewart v. Platt, 101 P. S. 731-739 25 L. Ed. 816; *In re* Ult, 105 Fed. 754, 45 C. C. A. 32; *In re* Prince & Walker (D. C.), 131 Fed. 546, 552; *In re* Soulier Cornice & Roofing Co. (D. C.), 133 Fed. 598, 963; Loveland on Bankruptcy (3rd Ed.), p. 7. See, also, Collier on Bankruptcy (6th Ed.), p. 497."

In the case at bar the bank was enjoined from 1935 to 1937 from foreclosing its lien while it was compelled to advance money for real property taxes, a prior lien on the property, to the extent of thousands of dollars.

From January 12, 1937, when adjudication in bankruptcy took place, and the agreement of January 12, 1937, as supplemented and amended, became effective, sequestering all of the rents, issues and profits to pay the bank's indebtedness, and providing for prompt liquidation of the property subject to the bank's lien, the trustee in bankruptcy without an order of the court, and over the protest of the bank, elected not to liquidate the property, but to operate the business of the bankrupt. In this connection he has incurred not only the income taxes for 1938 and 1939, the subject of this litigation, but additional income taxes for subsequent years, which together with interest on said unpaid income taxes, approximates the sum of $65,000.00 as of April 20, 1945. [Tr. Case No. 11059 pp. 10 and 11.]

As of February 10, 1945, the Referee in Bankruptcy found that there remained unpaid on the bank's obligation in excess of $450,000.00 of principal alone and that as of September 13, 1944, there was unpaid interest due the bank of $5,264.00. [Tr. Case No. 11059 p. 4.] As of Tuesday, November 23, 1943, it was stipulated that the balance of unpaid principal was $617,278.12. [Tr. p. 28.]

The bank's obligation draws interest at 4% per annum, so that additional interest at that rate from September 7, 1944, is also unpaid.

The Bank Holds a Deed of Trust Against All of the Property in Trust D7224 With a First and Prior Lien on All Income, Rents, Royalties, Issues and Profits Therefrom.

When the order authorizing the execution of the contract of January 12, 1937, as supplemented and modified, was before this Honorable Court in July of 1938 (*In the Matter of F. P. Newport Corporation Ltd.*, 98 F. (2d) 453) [Tr. p. 182], the question of the validity of said Trust No. D 7224 was in question. Also in question was whether the contract of January 12, 1937, surrendered the bankruptcy court's jurisdiction to administer the said estate and prolonged or "projected into the future" the liquidation of the bank's claim.

In that decision this Honorable Court held:

> "The conveyance and assignment by the Bankrupt to the bank, together with the Declaration of Trust executed by them, constituted a Deed of Trust."

And again:

> "We hold, therefore, that the Deed of Trust was valid and enforceable."

And again:

> "In approving, with modifications, the agreement of January 12, 1937, the trial court has not, as contended by appellant, surrendered its jurisdiction to administer the bankrupt estate. The court retains and is exercising that jurisdiction by and through the trustee in bankruptcy."
>
> "Nor is it true that, under the agreement, administration of the estate will be unduly prolonged, or, as appellant says, 'projected into the future.' Under the agreement as modified, liquidation of the bank's

claim must be completed on or before September 7, 1940. That does not seem to us an unreasonable time."

Thus we see that this court found said agreement valid as being no surrender of the jurisdiction of the bankruptcy court nor as unduly delaying or projecting into the future the liquidating of the bankrupt estate on which the bank held its lien. The court found that by the contract the liquidation of the bank's claim must be completed before September 7, 1940, which was a reasonable time for liquidation according to the opinion.

In this connection we call to the attention of this court paragraph 7 of the Certificate of Review of Referee Utley in case No. 11059, which case is being heard concurrently with this case, where he says:

> "There is now owing and unpaid to said Bank on account of the secured obligation hereinbefore mentioned in excess of $450,000.00 in principal; that heretofore and on the 31st day of October, the Referee made an order herein denying without prejudice the petition of the Security-First National Bank of Los Angeles, for leave to foreclose under the terms of its Trust, pursuant to which it held title to the bulk of the properties of this estate as security for the money so owing it.
>
> By the terms of said order it was provided, among other matters, that the Bank might renew said petition to foreclose at any time on or before June, 1945, if there should be a change in circumstances which would seriously prejudice the interests or security of said Bank. Heretofore interest owing said Bank has been duly paid as it fell due, pursuant to the orders

> of this court. Said Bank now threatens to renew its said petition for leave to foreclose if the interest above mentioned is not paid." [Tr. Case No. 11509 pp. 5 and 6.]

Thus we see that the bank, after a decade of time, is still restrained from foreclosure.

And the bankruptcy court has now ordered that income taxes, incurred by its trustee while holding off the bank and operating the business of the bankrupt instead of liquidating the property, may be paid out of rents, royalties, and income on which the bank has a first and prior lien and which, by the agreement of January 12, 1937, as supplemented and amended, were sequestered for the payment of the bank's indebtedness.

The Rents, Issues and Profits, Including Oil Royalties and Rents, Are Subject to the Lien of the Bank and Sequestered for the Payment of Its Indebtedness.

The Declaration of Trust in Trust D 7224 in Article Sixteenth thereof provided:

> "All proceeds and avails arising from rents, issues and sales of the trust property, or otherwise, shall be paid to and received by the said Trustee." [Tr. p. 54.]

By the terms of Article Twentieth the bankrupt had no right, title or interest in or to the property covered by the trust, "the sole right and power of the beneficiary hereunder being to enforce the performance of the terms of this trust as expressly set forth in this Declaration." [Tr. p. 63.]

Thus we see that all the royalties, rents, issues and profits were hypothecated with the bank as security for its indebtedness. These rents, issues and profits were part of its *primary security*. The bank was legal and equitable owner of said property.

That parties may convert their interest in and to trust real and personal property into personal beneficial interests has been expressly decided in California. See

> *Wright v. Security-First National Bank of Los Angeles,* 35 Cal. App. (2d) 264.

In the contract of January 12, 1937, as modified and amended, the bank waived its right to foreclose by a pledgee's sale of the bankrupt's beneficial interests in Trust D 7224.

The appointment of a Receiver in Bankruptcy in March, 1935, and the injunction barring foreclosure sale by the bank could not take from the bank its legal right to the rents, issues and profits of the trust estate and these rights remained unimpaired during the receivership. In fact such injunction against sale effected a sequestration of said rents.

The contract of January 12, 1937, as modified and amended, was entered into to break out of the deadlock imposed by the court and start liquidation.

This contract recites:

> "The Bankrupt and Receiver are desirous of further postponing the foreclosure by the bank of said security for non-payment of said indebtedness, and are desirous of starting the immediate liquidation of said indebtedness by the Bank, by the sale of certain of the real properties held by the Bank in said above referred to trust.

> The Bank is willing to delay further the foreclosure of the said security and will agree to the immediate sale of certain of the assets in said Trust on the terms, and subject to the conditions hereinafter contained, and not otherwise, hence this Agreement." [Tr. p. 102.]

The Referee found in approving the execution of the said agreement:

> "That unless the said proposed contract between the said Bank, the bankrupt and the trustee of this estate is executed promptly, *in order to permit liquidation thereunder* and protection of the assets held as security by the said Bank and of this estate, the said Bank threatens to withdraw all negotiations for the amicable liquidation of the property of this estate and insist, by reason of the heavy carrying charges of said property and the long period of time during which said obligation has been in default and the failure of the bankrupt or the receiver or trustee of the bankrupt estate to make any payment on said obligation or for taxes, assessments or interest or other carrying charges, on its right to an immediate foreclosure of said obligation and the sale of said property. That it is highly improbable that one single purchaser, or any group of purchasers acting in concert, could be found who would be willing to pay on a sale thereof the sum of $1,351,729.38, plus trustee's fees and expenses, interest and advances, to which the Bank would have been entitled upon a foreclosure and sale under the terms of its security." [Tr. pp. 170-171.]

The decision of this Honorable Court reversing the District Court's order rejecting the claim of the United States Government for income taxes for the years 1938

and 1939, holding them to be a valid charge against the Trustee in Bankruptcy, expressly calls attention to the fact that the Trustee in Bankruptcy was not liquidating the property of the bankrupt estate as called for in the agreement of January 12, 1937, but in fact was operating the business of the bankrupt and hence was subject to income taxes. Although the bank was no party to said proceeding, we point to this decision to show that had the trustee liquidated under the agreement as called for thereby, no tax would have been incurred. This decision was introduced in evidence by the United States Government [Tr. p. 255] by reference. It is found in Vol. 133 F. (2d), page 677.

The point made is that, if the trustee failed to liquidate as the contract provided, that his expenses as an operating trustee, including income taxes, may not be charged against the royalties, rents, issues and profits lest the bank's security be frittered away by the trustee. We again refer to the decision of this Honorable Court in the case of

In re Williams, 156 Fed. 934 (1934),

cited and quoted from *supra*, to show that may not be done.

The contract of January 12, 1937, as supplemented and modified and then approved by Judge McCormick and this Honorable Court, expressly provided:

> "While the said Declaration of Trust No. D 7224 and the Contract of January 12, 1927, provide expressly that all moneys from Sales and Leases of Property in said Trust shall be paid to and be received by the Bank, it is, nevertheless, agreed, in order to comply with the bankruptcy law requiring that all bankruptcy funds be accounted for by the

Trustee and be disbursed by him only upon checks or warrants countersigned by the Referee, that all such moneys shall be paid to said Trustee in Bankruptcy, and, until the indebtedness due the Bank has been paid, shall be by him forthwith paid over in full to the Bank, to be distributed in accordance with the terms of said Trust No. D 7224, and the agreement of January 12, 1937, as modified hereby."

"Recognizing that the Bank has a prior right to the moneys in the preceding paragraph mentioned until the indebtedness due it has been paid, it is therefore expressly understood and agreed that such funds of money so paid to and received by the said Trustee in Bankruptcy from Sales or Leases or other disposition of property under said Trust shall, until the indebtedness due the Bank has been paid and except as hereinafter provided, be, while in his possession, impressed with the lien of the Declaration of Trust securing the indebtedness owing to the Bank, and such funds or moneys shall be deposited by the Trustee in Bankruptcy in a separate bank account and not commingled with any other funds of the Bankrupt Estate, and shall be deemed earmarked for application on the Bank's indebtedness as provided in said agreement of January 12, 1937, and this supplement thereto, and, except as in said agreement and said supplement provided, shall not until, the indebtedness due the Bank has been paid, become any part of the general assets of the Bankrupt Estate." [Tr. pp. 129, 130.]

The above language provides, as clearly and unambiguously as the English language is capable of providing, that in giving up its right to collect the rents, issues and profits from the properties held by it in Trust No. D 7224, and allowing the Trustee in Bankruptcy to collect the same, that it did not waive the right to have the same

immediately paid over to it *in full* to be distributed in accordance with the Declaration of Trust D 7224, and the said agreement of January 12, 1937, as supplemented and modified.

The contract expressly recognized that the bank had a prior right to these incomes, rents and royalties and the proceeds from sales until its indebtedness was paid in full. The contract recognized that all such funds while in the hands of the trustee were impressed with the lien of the Declaration of Trust. They were required to be kept segregated by the Trustee in Bankruptcy in separate bank accounts and not be commingled with other funds of the bankrupt estate. They were "earmarked" for application on the bank's indebtedness. They were to become no part of the assets of the bankrupt estate.

This agreement, so plain and unambiguous, sequestered these funds for the bank's indebtedness. They did not become a part of the bankrupt estate, but were to be held in trust by the Trustee in Bankruptcy for the bank and be paid over in full forthwith to the bank.

The District Court and this court understood that these funds belonged to the bank when they approved the contract.

The District Court has, by the order appealed from, directed its Trustee in Bankruptcy to scrap the agreement it approved in 1937 and to pay to a third party, the United States Government, expenses incurred by the trustee in operating the bankrupt's business out of the bank's funds.

We shall show, that by such sequestration agreements, such rents, issues and profits are not assets of the bankrupt estate, and are not available to pay such costs of administration.

Both Federal and State Decisions Sustain Such Sequestration Agreements and Enforce the Terms Thereof.

In the first place we may comment that the right to contract about property is a right guaranteed by both Federal and State Constitutions. The principle is well and briefly stated in Cal. Jur., Vol. 5, Section 135, page 736, as follows:

> "It has come to be well recognized that the rights of liberty and pursuit of happiness in which the individual is protected by the Constitutions of the United States and of California, apply as fully to his right of contract, untrammeled by unnecessary regulations as they do to the freedom from arrest or restraint of his person. Similarly the right of acquiring, possessing and protecting property guarantees to the individual the right to *contract with others respecting the use to which he may subject his property and the manner in which he may enjoy it.*"

The contract of January 12, 1937, as supplemented and modified, and as approved by the courts, vested in the bank, as its property, the royalties, rents and income from the properties held in its Trust D 7224. To permit the United States Government to invade them to pay the Trustee in Bankruptcy's income taxes violated the provisions of the Constitution against taking property without paying therefor.

It might be well to point out that there is no statute giving the United States Government a first and prior lien on real or personal property over valid contract liens.

The State of California has granted a first and prior lien on real estate in the State for the payment of State and County taxes against the same.

See

Political Code of California, Sections 3716 and 3788.

Hence the bank and the Trustee in Bankruptcy have annually paid these State real estate taxes to protect the trust properties from such a lien. If the United States Government possessed such a lien prior to the bank's rights, this controversy would not be taking this court's time.

Section 2897 of the Civil Code of California provides that "other things being equal, different liens upon the same property have priority according to the time of their creation, except in cases of bottomer and respondentia."

The Federal statutes do give the Revenue Department the right to file a lien against property of an income tax debtor for income taxes due and unpaid, but such lien would clearly be behind and subsequent to the contract lien of the bank on the trust property and the rents, issues and profits therefrom. That no doubt explains why the Government instead of standing on its lien rights is trying to "back in by a side door" and take money belonging to the bank to pay the trustee's income tax debt.

The sequestration of the rents, issues and profits from the trust estate was, as we have heretofore pointed out, an accomplished fact long before any claim of the Government against the trustee for income taxes arose.

When the court restrained the bank from continuing with the foreclosure of its security in 1935 and placed a receiver in charge the effect was a sequestration of said rents, issues and profits to which the bank was entitled under its Declaration of Trust.

When the contract of January 12, 1937, as supplemented and amended, was executed by the Trustee in Bankruptcy with the full approval of this court, and the trustee was ordered to perform the terms thereof, the sequestration was continued on the terms and conditions of the contract and the rights of the bank to the said rents, issues and profits became absolute.

The case of

In the Matter of Wakey (C. C. A. 7th, 1931), 50 F. (2d) 869, 18 Am. B. R. (N. S.) 512,

illustrates the principle. In this case the Trustee in Bankruptcy collected the rent from the mortgaged premises for two years. The mortgagee then petitioned the court for an order directing the trustee to apply the rents and profits to the payment of the interest due upon the mortgage. The referee denied his petition and his order was affirmed by the District Court. This appeal was taken from the court's order. The court, in 18 Am. B. R. (N. S.) 512, *supra,* at page 513 said:

> "It is not questioned but that the rents and profits of land, as well as the land, may be the subject of a valid mortgage lien (citations). It seems equally clear in Illinois that the lien upon the rents and profits is not ordinarily enforceable until the mortgagee begins foreclosure proceedings, and a receiver, or other officer appointed by the court, takes possession of the property described in the mortgage. Dillon v. Dyer, 258 Ill. App. 144. . . . after the appointment of such receiver in the mortgagee's suit, the mortgagee's right to the rents thereafter collected is clear. Roher v. Deatherage, 336 Ill. 450; Dillon v. Dyer, *supra;* St. Louis Union Trust Co. v. Wabash

etc., 258 Ill. App. 9. In this case the mortgagee made no application for permission to foreclose his mortgage, and not until after two years' rent had been collected by the trustee did he ask to have the same applied upon his mortgage. This failure on his part to assert his lien would have been fatal to his application here but for the intervention of the bankruptcy proceedings. Doubtless the bankruptcy proceedings and the appointment of the trustee dispensed with the requirement that the mortgagee should start foreclosure proceedings and secure the appointment of a receiver. . . . Our conclusion is that the trustee in bankruptcy represented all of the creditors, the secured, the preferred and the unsecured, that under Isaac's Trustee v. Hobbs Tie and Timber Co., *supra,* 282 U. S. 734, 17 A. B. R. (N. S.) 273 (decided Feb. 24, 1931), appellant could take no steps to perfect a lien upon the rents save in the court of bankruptcy; that he correctly assumed that his rights would be protected by the court of bankruptcy when it came to distribute the funds in the trustee's possession, derived either from the sale of the farm or from the rentals of the farm. . . . In reaching this conclusion we have not overlooked the contention based upon the proposition that the provision of the mortgage covering rents and profits conveyed a right to a lien rather than an unqualified lien—a condition precedent to the creation of such lien was necessary, viz.: the appointment of a receiver to collect the rents and profits. Inasmuch as this receiver would ordinarily not be appointed, except upon a showing that the property was insufficient to pay the mortgage debt, and inasmuch as the income belonged to mortgagor, or in case of his bankruptcy to the trustee, until such receiver was appointed, it has been argued that such income belonged to the

trustee in the absence of a showing that the property was insufficient to satisfy the mortgage debt. The weakness of this argument lies in the fact that the trustee, as the successor of the mortgagor, collected the rents and profits and held them for the benefit of the unsecured creditors, the secured creditors and the preferred creditors. He occupied a position akin to that of a receiver appointed at the instance of a judgment creditor in a suit where the first mortgagee is made a party, and the order appointing the receiver fails to designate the parties for whom the receiver should collect the rents and profits."

The facts in the case at bar are much stronger. Here under its Declaration of Trust actual title to the legal and equitable estate of the debtor passed to the bank as Trustee and with the title the right to collect and disburse all income was granted it. When the bank's foreclosure was restrained in 1935 and a receiver in Bankruptcy appointed to take possession of the bank's property, the right to all income had vested in the bank. In 1937 when the contract of January 12th as amended was entered into, the right of the bank to receive all the income, rents, royalties etc., was expressly preserved to the bank and continued the sequestration thereof.

A very recent case, decided in 1936 by our Circuit Court of Appeals for the 9th Circuit, decided the validity of such sequestration by the secured creditor and discusses facts very analagous to the case at bar, but not so conclusive as those herein.

The case is:

American Trust Co. v. England, 84 Fed. (2d) 352.

In that case there were three mortgages on bankrupt's real property. Upon default, acting under the terms of the third mortgage, the Trustee in Bankruptcy of the third mortgage took possession and collected rents. Thereafter the Trustee in Bankruptcy of the first mortgage moved to sequester the rents thus collected, which motion was held to be the equivalent of the taking of possession by the first mortgagee under its mortgage. The Trustee in Bankruptcy of the mortgagor also claimed these rents. The court held that the Trustee in Bankruptcy of the third mortgagee was entitled to hold the rents collected by him as against the Trustee in Bankruptcy of the Mortgagor, claiming them for the benefit of the unsecured creditors.

The court held that the Trustee in Bankruptcy of the first Mortgagee was entitled to the rent *subsequent* to the filing of its sequestration petition.

The court likewise held that where a mortgage provided that in case of default the mortgagee might take possession of and manage mortgaged property, the demand by first mortgagee upon Trustee in Bankruptcy of third mortagee in possession of property for sequestration of rents followed by a sequestration order held equivalent of taking possession, entitling first mortgagee to proceeds of operation of mortgaged property subsequent to sequestration proceedings. (Civ. Code, Cal. No. 2927; C. C. P. Cal. No. 744.)

The court at page 356, said:

> "The demand of the appellant upon the Trustee for sequestration of rents and the referee's order for the sequestration, is the equivalent of the taking of pos-

session by the appellant under its trust instrument (Mortgage Loan Co. v. Livingston C. C. A. 8) (45 P. (2d) 28). In that case the mortgagees were entitled to possession under the provisions of the mortgage, but the possession was in the hands of a Receiver in Bankruptcy proceedings. The mortgagee requested the Receiver to sequester the income from the mortgaged property from other income of the receivership. The receiver stated he would so sequester the income. Afterwards, as here, the mortgagees filed a petition for leave to foreclose the mortgage. This was at first denied without prejudice. Thereafter, as in the present case, it was granted. In holding that the mortgagees were entitled to this income remaining in the hands of the receiver, the court said:

'In effect the mortgagees made themselves parties to the bankruptcy proceedings, recognized the receivership, *but never acquiesced in an appropriation by him of the rents and issues of the property to the use and benefit of the general creditors, but promptly and persistently insisted that these rents and issues be impounded by the receiver, and either be used in the discharge of the taxes and insurance or be turned over to them—while it is true these mortagees acquiesced in the collection of these rents and profits by the receiver, they did so on the understanding that they were impounded and would be properly applied or accounted for,* and it cannot be said that they ever acquiesced in an appropriation of them by the receiver on behalf of the general creditors. They were of course, unable to take possession of the property from the receiver, except on an order of the court, and the record in this case warrants the conclusion that the receiver was acting not only on behalf of the general creditors, in so far as this property was concerned, but was acting also on behalf of these mort-

gagees, and he collected and impounded these pledged rents and issues, keeping them separate and apart from his other accounts for apparently no other purpose than to make them available as a part of the security under this second mortgage . . . We are of the view that the mortgagees in effect intervened in the receivership proceedings in aid of their proceedings to foreclose, and this intervention operated to charge *all of the net income arising from the operation of the property by the receiver with the lien of their mortgage.. . . . To hold that the mortgagee had a legal right to these rents and issues under the provisions of their mortgage, but that they should be precluded from recovering the same because they had not technically pursued a legal remedy is to overlook the fact that the property was in control of a court of equity, and that equitable remedies commensurate with the legal rights of the parties should be available. To take from the mortgagees the property to which confessedly they are entitled under the pledge provision of their mortgage, and transfer it to the unsecured creditors of the Bankrupt, appears to us as harsh, inequitable and unwarranted. . . . This is a proceeding in equity, and we find funds in the possession of the Trustee in Bankruptcy to which the appellant made proper claim and is in a position equivalent to his possession of the property as mortgagee in possession."* (Emphasis added.)

The facts in the case at bar are even stronger than those in the *American Trust Co.* case. In the case at bar the bank had the legal title with the exclusive right to collect all rents. It had begun foreclosure, as in the case above. It was enjoined and a Receiver was placed in possession of the property, as in the above case. When the court barred it from foreclosure and took possession of the

property by its Receiver it in effect was acting for the secured creditor and collected the income for it.

When the Receiver, and subsequently the Trustee in Bankruptcy, agreed to collect the rents and pay them over *in full* to the bank, that according to the above decision, amounted to giving possession to the bank of all such rents with all the rights of a mortgagee in possession.

To allow this fund which belongs to the bank and which the court's officer with its full approval agreed to collect and pay over *in full* to the Bank, to be diverted to pay other creditors and claimants would, as the court said in the above case, be "harsh inequitable and unwarranted."

Bear in mind the bank would never have signed any such contract if it had not had the word of the Trustee, and the entire assurance of the court, by its order to the Trustee to perform, that all of said rents would be forthwith paid over to the bank as soon as collected.

Another Federal case arising out of bankruptcy which discusses the right of the mortgagee to the rents collected by the Trustee is

> *Associated Co. v. Greenhut*, 66 Fed. (2d) 428 (3rd Circuit).

In this case the appellants held a first and second mortgage, respectively, upon certain property of the bankrupt. Both mortgages contained an express assignment of the rents. Default occurred on both mortgages and the District Court with consent of the Trustee, allowed a foreclosure of the mortgages, and the sale resulted in a deficiency on both mortgages. Both mortgagees made an application for the rents collected by the Trustee from the date of his appointment to the date of the foreclosure, less administration expenses.

The court, at page 429, said:

> "The issue of this case is whether rents collected between the adjudication in bankruptcy and the sale under mortgage foreclosure proceedings belongs to the trustee of the bankrupt estate or to the mortgagee. The referee held that they belonged to the trustee, and in that he was sustained by the District Court."
>
> "The rule of law in this Circuit is uniform that, as between mortgagee and trustee in bankruptcy, the rents collected between adjudication and the sale, under foreclosure proceedings, belong to the mortgagee under claim of deficiency where the proceeds of the sale are insufficient to pay the mortgage indebtedness . . . *The mortgagee is the equitable owner of the bankrupt's real estate covered by this mortgage, and it would be inequitable to take the rents from what is really his property and divide them among general creditors* . . . There is another reason why the rents thus collected should go to the mortgagee under claim of deficiency . . . Both bonds and mortgages expressly assigned the rentals to the mortgagee in case of any default in the performance of the covenants. The assignment, though conditional, became absolute, effective and enforceable upon the default which admittedly occurred." (Judgment of the District Court reversed.) (Emphasis added.)

This case again announces the principle that "The mortgagee is the equitable owner of the bankrupt's real estate covered by this mortgage and it would be inequitable to take the rents from what is really his property and divide them among the general creditors."

In the case at bar we have the far stronger state of facts. The court itself approved the contract with the lien holders, providing that if the bank would forgive part

of the debt, reduce the interest rate and forego foreclosure for several years, its officer, the Trustee in Bankruptcy would collect the rents from the encumbered property and forthwith pay them over to the bank *in full*. And, until this proceeding of the Government was instituted, the Trustee has paid over all of said rents in full except such as the bank expressly waived the right to receive.

The United States Government is only a creditor of the Trustee in Bankruptcy and has no right whatever to funds belonging to the bank.

By the terms of the agreement with the bank the Trustee has no right to touch these funds for the payment of any indebtedness he may incur as such Trustee. The agreement with the bank is clear and unambiguous. The Trustee, under the advice of his able counsel, proposed this agreement to obtain the benefits given up by the bank. The court approved the agreement with full knowledge of the rights retained by the bank to all the rents, issues and profits from the property. They have had those very substantial benefits under the contract. It would now be harsh and inequitable to let any one steal away these funds belonging to the bank.

The California decisions are fully in accord with the principles laid down by the 9th Circuit Court of Appeals and the other Federal decisions.

In the very recent case of

> *Mortgage Guarantee Co. v. Lee,* 61 A. C. A. 489 at 499.

the court said:

> "It appears to be well established law in this state that rent may be assigned as security, and as such is an independent, primary security for the indebtedness, so long as the debt remains unpaid."

In the case of

Title Guarantee & Trust Co. v. Monson, 11 Cal. (2d) 621 at 627

we find this language:

"Within, and as a part of the deed of trust, the parties thereto had the right to insert any lawful conditions as a part of the consideration for the creation of the debt for which the property was hypothecated, and therein, upon default in payment, to invest in the plaintiff not only the right of possession, but also the right to rentals. Snyder v. Western Loan & Building Co. 1 Cal. (2d) 697, 702 (37 Pac. (2d) 86). And this covenant was equally binding upon a subsequent grantee of the land. To hold that, to the loss of the creditor, the covenants agreed upon between the debtor and the creditor thereafter could be repudiated by a subsequent grantee, as in effect is contended here, would be contrary to reason and fairness. The rights of the defendants were measured by the conditions and terms of the original trust deed. In Volume 41 C. J., p. 714, it is said: 'The purchaser of mortgaged premises will be entitled, as against the mortgagee, to recover or retain the possession only in case his vendor would have been so entitled . . . The purchaser is ordinarily entitled to all rents of the property accruing after the date of his purchase, unless they are expressly pledged in the mortgage as part of the security. Again, in the case entitled *Equitable Life Assur. Soc. v. McCartney,* 20 Fed. Supp. 37, the court says, 'The rights of the grantee of the mortgagor are no greater than that of her grantor, for she takes the property subject to the right to enforce the lien upon the rents'."

And on page 628, the same case, is found this language:

"In the case entitled *Owsley v. Reeves,* 179 Ill. App. 61, 63, appellant was deeded the premises 'subject to whatever lien appellees secured thereon by virtue of the trust deed'; and the court there said: 'Appellant cannot get away from the fact that his rights in the premises are subject to whatever lien was created in favor of the appellees by their trust deed. Rents and profits are the subject of mortgage. A mortgagee has a specific lien upon rents and profits of mortgaged land when they are expressly pledged by the mortgage as part of his security . . . Appellant, as subsequent purchaser, was bound by those terms of the trust deed . . .' And in the case of Townsend v. Wilson, 135 Ill. App. 303, 308, it appeared that the purchasers of the premises there involved took the land 'subject to' a mortgage conferring the right to the rentals therefrom upon the mortgagee or his agent, at the time of foreclosure. In referring to the purchasers, the court said, 'But their implied agreement . . . by accepting the deed with that proviso that it was subject to the mortgage, was that the land, the rents and profits mortgaged . . . should stand good for that debt and be charged with that debt as against any right they received by virtue of the deed. Their action in this case in claiming these rents simply amounts to a breach of their contract and they have no standing in law or equity in their claim to the rents'."

In the case at bar, not only was the right to the rents given the bank in its Declaration of Trust, but by the Contract of January 12, 1937, amending the Trust Declaration, the debtor expressly agreed to collect these rents and turn them over *in full* to the bank, and during such time as they remained in his possession the contract im-

pressed the lien of the bank thereon. Some of these rents have not been paid over as agreed, and the bank in its petition has asked the court to order them paid over in full at once.

In:

Mortgage Guarantee Company v. Sampsel, 51 Cal. App. (2d) 180

We find the plaintiff had a trust deed on the Villa Riviera Apartments, in Long Beach, Calif., and a chattel mortgage on the personal property therein. Both the trust deed and chattel mortgage provided that the rents, issues and profits were assigned to the plaintiff as further security and the trust deed provided in event of default in the trust deed or in the event of waste as defined therein, the holder thereof either by itself or by a Receiver to be appointed by a court therefor, could take possession and collect rents, issues and profits. Villa Riviera Inc., the record owner, defaulted in payment of installments of principal and taxes, and plaintiff elected to declare the note due. The plaintiff filed a court action for possession of the property, and for the rents, issues and profits and the same day the court appointed a Receiver. Thereafter the Receiver collected the rents for over four months at which time the court ordered the Receiver to deliver possession of the premises to the plaintiff. The plaintiff, subsequent to filing of this action caused the property to be sold under the trust deed and likewise foreclosed the chattel mortgage. Plaintiff purchased the property, leaving a substantial deficiency. Subsequent to the date of sale, the Villa Riviera Inc., was adjudicated a bankrupt and the defendant was appointed trustee. The dispute in this case is whether the moneys in the hands of the Receiver should be paid to respondents to apply upon the balance due, or should be paid to the

appellant, Trustee in Bankruptcy. The appellant contends (1) the exercise of power of sale under trust deed terminates right of beneficiary to rents collected by the Receiver pending the sale, and (2) that when the right of collection and possession is granted in such a deed of trust and chattel mortgage to the beneficiary or receiver upon default, such right does not include rents accrued, but unpaid, at time of default and demand therefor. The court held that the California Supreme Court in the four consolidated cases of *Hatch v. Security-First National Bank*, 19 Cal. (2d) 254, answered appellant's point by holding that a creditor in proceeding against additional security was not securing a personal judgment, nor a deficiency judgment.

The court, in the said case of *Mortgage Guarantee Company v. Sampsel*, said, at pages 186, 187, 188, 189 and 190:

> "There can be no question but that the assignment of rentals in the deed of trust constituted additional primary security with the real property described in the deed of trust and the personal property described in the Chattel Mortgage. (Title Guarantee & Trust Co. v. Monson, 11 Cal. (2d) 621). But even if these rentals did not constitute additional security, the action brought for them was not an action to obtain the money judgment mentioned in Section 580a, nor was the order of the court requiring them to be paid to the respondent a deficiency judgment in the sense in which it is used in Section 580b. Therefore, in no event would the sale under the deed of trust of the real property therein described prevent the creditor from proceeding to foreclose his chattel mortgage and to obtain the rentals which in the deed of trust were assigned to him for security."

"The general rule on the question of who is entitled to rents of mortgaged real property is set forth in 41 C. J. page 632, 'Unpaid rents accrued prior to taking appropriate steps to subject them, unless conveyed to the mortgagee by a valid assignment or expressly pledged to the mortgagee, belong to the mortgagor, but there is authority to the contrary.'

"The general rule, too, upon the question of whether the pledge in the mortgage of the rents, issues and profits for the security of the mortgaged debt refers to prior accrued rents is set forth in *Re* Clark Realty Co. 234 Fed. 576 (148 C. A. 342) at page 583, where the court says, 'As to the claim of the mortgagees to the rents and profits: The Referee held that these rents belonged to the mortgagees from the time when by intervening petitions they claimed them, but denied their rights to them prior to the date of the claim. Much of the brief of counsel for the mortgagees is devoted to the proposition that the clause in the mortgages including with the property mortgaged 'all the rents, issues and profits issuing and to issue out of said premises,' is valid. There can be no question as to the validity of this clause. The question is as to its effect. This clause in the mortgage did not give the mortgagees an absolute right to the rents. Until there was a default and until the mortgagees made some claim or demand for the rents, they belonged to the mortgagor. Until the mortgagee takes some steps *to sequester* the rents he is not entitled to them. 'Ordinarily the mortgagor is entitled to rents and profits accrued up to the time that the mortgagee enters, or brings his right of entry or his bill to foreclose, and this right inheres in a trustee in bankruptcy. (Citing cases.) Under these authorities the decision of the referee and the district court giving to the mortgagees the rents from and after the time

they made claim for them and denying the rents accruing prior to such claim was correct'."

"The general rule is followed by the California Courts is shown in Bank of America v. Bank of Amador, 135 Cal. App. 714, at page 721: ('The fact that the rents, issues and profits of the mortgaged property are expressly pledged for the security of the mortgage debt, with the right in the mortgagee to take possession upon default, does not entitle the mortgagee to the rents and profits until he takes actual possession or until actual possession is taken in his behalf by a Receiver. (Simpson v. Ferguson, 112 Cal. 180 . . .) Thus, the fact that in the instant case the trust deed purported to include the rents, issues and profits as security would not avail, unless the trustees were in actual possession at the time of the execution of the Chattel Mortgage belonging to the plaintiff.' To the same effect, Binney v. San Dimas Lemon Assn., 81 Cal. App. 213; Casey v. Doherty, 116 Cal. App. 42; Becker v. Munkelt, 27 Cal. App. (2d) 761."

"The decision in the Monson case (11 Cal. (2d) 621), fixes the date of demand as the date upon which the mortgagee's right to the rent accrues, so it is immaterial whether thereafter a receiver is appointed or not. The mortgagee is entitled to the rents from that date on."

In the case at bar not only did the court in the first instance bar foreclosure and appoint a receiver, to collect the rents, but by the contract of January 12, 1937, as modified and amended, and its express approval of said contract, it sequestered *all of the rents issues* and *profits* for the bank and ordered them paid over *in full* to the bank forthwith. From the effective date of said agreement, all

of the said rents, issues and profits belonged to the bank and it was constructively in possession thereof.

In the very recent case of

Childs etc. Co. v. Shelbourne Realty Co., 23 A. C. 265, (Dec. 8, 1943).

the owner of certain real property executed a ninety year lease on which the lessee subsequently erected a substantial building, The lessee to finance the building, executed a trust indenture, which expressly provided it was subject to the prior lease, under the terms of which the owner or lessor had a prior lien on buildings and improvements on the premises and rents. The trust indenture likewise created a lien on the rents in favor of the trust. The lessee defaulted on the trust indenture and the trustee under the trust indenture designated *the lessee as its agent to collect the rents, deposit the same in a special account and it was agreed that all such funds so deposited should belong to the trustee.* The owner forfeited the lease because of defaults of the lessee and claimed the rents collected by the trustee prior to the owner taking possession of the premises under and by virtue of his prior lien. *The court held that notwithstanding the prior lien of the owner of the property, the trustee's possession of the rentals was established by making the lessee its agent to collect rents and manage the property, and that* the lessor's lien could not be enforced until it obtained possession of the property. The court at page 269 said:

> "Prior to the time Childs, the lessor, took possession, the bank was an assignee of some of the leases between Shelburne and its subtenants, and a lien holder in possession as to the balance of the subrentals. The bank's possession was established by making Shelburne its agent to collect rents and man-

age the property. (Snyder v. Western Loan & Building Co., 1 Cal. (2d) 697 (37 Pac. (2d) 66); Kershaw v. Squier, 137 Kan. 855 (22 P. (2d) 468); Reichert v. Guaranty Trust Co., 261 Mich. 315 (246 N. W. 132). There is no reason to make a distinction in this case between the bank's position as assignee and its position as lien holder in possession of the premises."

This taking of possession by the Bank of America by making Shelburne, the lessee, its agent to collect the rents is exactly the same process used by this bank in the case at bar when it (with the consent and approval of this court) made a contract with the Trustee in Bankruptcy to collect and pay over to the bank all the rents, issues and profits of the Trust Property.

In the *Childs* case, *supra*, on page *270*, the Supreme Court of California used this language:

. . . "And until a mortgagee obtains lawful possession, the mortgagor in possession may collect the rents as they fall due. Or to put it another way, the mortgagor must actually acquire possession of the mortgaged property by consent *or lawful procedure* or must secure the appointment of a receiver in order to perfect his claim to the rents." (Citing cases.)

And again, on page 271, the court said:

"It has been pointed out that, *in the absence of a specific agreement,* the right to rentals does not accrue until the lienor obtains lawful possession of the realty. The bank may keep the subrents it collected."

As has been so clearly pointed out in both the Federal and State decisions cited hereinabove, the enjoining of trust deed holder or mortgagee from foreclosing its security by a bankruptcy court where the right to receive

said rentals was provided in the contract, has the effect of sequestering the rentals for the lien holder and giving it constructive possession. Also, the above cases recognize the rights of the lien holder to make a valid contract with the mortgagor to collect the rents, issues and profits for the lien holder and this, the cases hold, is *constructive possession* of the lien holder and entitles him to receive such rents, issues and profits.

In the case at bar there is no dispute of the fact that the lien holder, this bank, made an express contract with the mortgagor, the Trustee in Bankruptcy, to collect these rentals and to pay the same over to the bank *in full.* As we have repeatedly shown, the possession of the Trustee in Bankruptcy is the possession of the bank and all of these rentals belong to it.

There is one more California case which is enlightening on the issues involved in these proceedings, for in that case was involved a contract between the holders of a Deed of Trust who held also an assignment of a lease on the property and a Trustee in Bankruptcy. It is strikingly analogous to the contract in the case at bar.

It is

Steinberg v. Evans, 20 Cal. App. (2d) 124.

In this case the owner, a Mrs. Stein, entered into a lease of real property to Edwards Bros. for a mortuary. She borrowed $60,000.00 from defendant and respondent on April 9, 1930, with which to erect the demised building and gave defendant a deed of trust on the property to secure the payment of said obligation. On June 16, 1930, Stein also, as additional security, assigned the lease to Edwards Bros. to the defendants with the right to collect the rents upon default in the payments under the Deed of Trust.

In January of 1931, the Trust Co. holding title under the said deed of trust started foreclosure proceedings by giving notice of default.

On May 18, 1931, an involuntary petition in bankruptcy was filed against Stein and thereafter a trustee in Bankruptcy was appointed.

On November 19, 1931, the defendants and respondents as holders of the Trust Deed and Assignment of the lease, entered into an agreement with the Trustee in Bankruptcy in the Stein bankruptcy matter.

This agreement provided for:

1st. A rescission of the election to foreclose the trust deed, declaring the entire amount of the debt due.

2nd. The $60,000.00 note and trust deed was reinstated in good standing.

3rd. That the rentals payable by Edwards Bros. under said lease accrued and payable on October 15, 1931, and all thereafter falling due should be paid to the Trustee in Bankruptcy.

4th. That the said Trustee in Bankruptcy should *forthwith pay said rents to the holder of the Trust Deed, the defendants and respondents.*

5th. That out of said rents the following was to be paid by the owner of the Trust Deed:

(a) Accrued and accruing interest on the $60,000.00 note.

(b) Installments on the note at $2,000.00 every six months commencing April 9, 1931. All unpaid balance to mature and be payable on April 9, 1940.

6th. If property be sold by the Trustee in Bankruptcy it must be for sufficient to pay the entire indebtedness of defendants and his expenses, the note to become due and payable on any sale being made.

7th. If defendants do not get the payment of the entire rentals, they may themselves enforce payment against Edwards Bros.

8th. The note and deed of trust remained in full force and effect in accordance with the original terms, except as modified by the stipulations and agreements.

9th. That so long as rents are paid to defendants no default will be called on the said note and trust deed.

10th. The stipulation recited it was to avoid litigation and if not carried out, the parties are remitted to their former rights.

The Trustee in Bankruptcy collected from lessees certain rents and paid them over to the defendants and respondents, until on May 25, 1934, when respondents, the owners of the note and trust deed, gave notice calling due all amounts on the note and trust deed because of breach of the agreement and default in payment of taxes and interest.

Thereupon the Trustee in Bankruptcy sold the said real estate and all rights in connection therewith, but subject to the said deed of trust, the lease and its assignment to one S. H. Steinberg, Trustee, for $350.00 obviously not enough to pay off the indebtedness due defendants and respondents, and hence a breach of its agreement or stipulation. Steinberg Trustee then, on or about June 20, 1934, filed suit to enjoin the respondents from selling the property under said deed of trust, and the court enjoined defendants by judgment on September 20, 1934. During

the pendency of said suit respondents filed a new Notice of breach and Intention to sell and recorded the same on September 1, 1934.

On November 7, 1934, Steinberg filed the present action to enjoin respondents from foreclosing and for an accounting for rents collected and turned over to the respondents under the agreement or stipulation with the Trustee in Bankruptcy on the Steinberg bankruptcy matter.

The court rendered judgment against the plaintiff for an injunction and approved the accounting of respondents as being strictly in accordance with the said contract between said Trustee in Bankruptcy and the respondent, holders of the Deed of Trust and assigned lease. The contention of the plaintiff that certain rentals accruing prior to the date of the recording of the second Notice of Default and intention to foreclose belonged to the plaintiff as owner of the property, was not sustained.

This decision is based upon the holding of the validity of such a contract as was made with a Trustee in Bankruptcy by the terms of which he collected rentals and *forthwith turned them over in full* to the trust deed holder.

The analogy to the contract in the proceeding at bar is striking. Each sequestered the entire rentals of the encumbered property for the lienholder by allowing the Trustee in Bankruptcy to collect them with a covenant to forthwith pay them over to the lienholder in full. The consideration was largely the same, to-wit: the abandonment of foreclosure proceedings, the reinstatement of the deed of trust and giving of easier terms of payment. So long as the trustee held title to the property he paid over the rents to the defendants.

The cases herein cited recognize that the holder of a mortgage or trust deed note with a pledge of the rents, issues and profits has a vested estate in the subject of its security. This vested security may not be taken from it, as the Court's order does, in payment of expenses of administration without the consent of the secured creditor. Income taxes are but an expense of the Trustee in Bankruptcy and cannot be paid out of income vested in the bank. This point has been ruled upon expressly by the Circuit Court of Appeals (9th Circuit) in the case of

In re Williams' Estate, 156 Fed. 934 (*cited supra*).

On page 939 the court said:

> "It is true that the record in the case shows that the lienholder voluntarily came into the bankruptcy court and asked that the property covered by its liens be sold by that court. By coming into the bankruptcy court, therefore, the holder of a valid lien upon the estate of a bankrupt comes into an appropriate place and into a court amply able to enforce and protect his rights. By doing so the lienholder waives none of his rights. The enforcement of his lien in another court would entail upon the proceeds of the property upon which the lien exists the payment of the appropriate court costs, and so in the enforcement of such lien in a court of bankruptcy, the proceeds of the property of the bankrupt upon which such lien exists is properly chargeable with the costs of such court appropriate to such enforcement, *but with no other or further costs. They are not chargeable with the general costs of the administration of the bankrupt's estate, such as the services of a receiver in carrying on the business of the bankrupt, the expenses and losses of such business, the fees of*

the attorney for such receiver, the general fees of the trustee or those of his attorney. If so, the valid lien upon the estate of the bankrupt which the bankruptcy act expressly declares shall be unaffected by any of its provisions, might very readily be destroyed, as it would unquestionably be, should such costs equal or exceed the proceeds in cases like the present, where the aggregate amount of the valid lien exceeds the proceeds of the entire estate of the bankrupt. In line with this ruling are the cases of Stewart v. Platt, 101 U. S. 731, 739, 25 L. Ed. 816; *In re* Utt, 105 Fed. 754, 45 C. C. A. 32; *In re* Prince & Walker (D. C.), 131 Fed. 546, 552; *In re* Bourlier Cornice & Roofing Co. (D. C.), 133 Fed. 598, 963; Loveland on Bankruptcy (3rd Ed.), p. 775. See, also, Collier on Bankruptcy (6th Ed.), p. 497." (Emphasis added.)

Here the court clearly points out that to allow the expenses and losses of a business, run by the Receiver or Trustee in Bankruptcy, might well destroy the value of the creditor's lien which the Bankruptcy Act so carefully preserves. Income taxes are merely an expense incurred by the Receiver or Trustee in Bankruptcy in operating a business and clearly are not chargeable to the funds pledged to the secured creditor.

In the United States Tax Service two recent cases are digested which bear on the controversy between the United States Government and the Security-First National Bank of Los Angeles as to payment of income taxes out of the oil royalties on which the bank has a valid first and prior lien.

The first case is

United States of America et al. v. Waddill, Holland & Flinn. Inc. et al., Virginia Supreme Court of Appeals, Record No. 2733, Jan. 24, 1944, from the Corporation Court of the City of Danville.

The substance of this case is as follows:

After an assignment by a taxpayer for the benefit of his creditors, the taxpayer's lessor under a written lease levied a distress warrant on the property so transferred for accrued and future installments of rent. On the sale of the property under order of court the United States intervened to claim priority of payment of its claim for taxes and interest due from the assignor pursuant to Section 3466, R. S. The court held that under the statute law of Virginia, as construed by its courts, the landlord has a *specific and perfected lien for such rent,* which relates back to the beginning of the tenancy and not merely an inchoate lien.

Therefore, judgment was given to the landlord and against the claim of the United States.

The United States Government based its contention on Section 3466 of the Revised Statutes (31 U. S. C. A., Sec. 191) which provided that whenever any person indebted to the United States is insolvent, or whenever the estate of a deceased debtor is insufficient to pay all his debts, the debts due the United States shall be satisfied first. This priority is by the statutes declared to extend to cases where an assignment for the benefit of creditors is made with insufficient funds to pay assignor's debts and to other classes of debtors, including bankrupts.

The court comments that this statute creates no lien in favor of the United States on the debtor's property, but merely confers on the United States Government a right of priority of payment out of such property in the hands of the debtor's assignee or their representatives under conditions specified in *U. S. v. Oklahoma,* 261 U. S. 253, 67 L. D. 638. Thus the court points out that the right of priority, *if any,* became fixed at the date of the assignment. If other creditors were not preferred *at that time* their claims will be subordinate to the Government's claim.

The court pointed out that the landlord did not dispute the above principle, but contended it had, under the laws of Virginia, *a fixed and specific lien* upon the property located on the demised premises for six months' rent, and that, therefore, its lien was superior to the Federal Government's "priority."

On this point the court said:

> "However, it seems to us that if before the Government's right of priority attaches, a creditor acquires *a specific and perfected lien on the property of the insolvent debtor,* the estate of the latter is, for all practical purposes, diminished to the extent of the claim secured by such lien, and the Government's right attaches only to the residue,"

and citing the following cases:

Ernst, Director, v. Guarantee Milmark, Inc., 200 Wash. 195, 93 P. (2d) at 325;

Spokane County v. U. S., 279 U. S. at p. 94, 49 S. Ct. at 325;

United States v. Knott, 298 U. S. at 548, 56 S. Ct. at 904.

The court held that under the Virginia laws the landlord had a perfected lien for the said rent and that this prior lien could not be invaded to pay the United States taxes given priority by statute.

This case but again brings out the sanctity of perfected liens, even against claims of the United States, for taxes which are given priority of payment in bankruptcy.

In the case at bar, the facts conclusively show that Security-First National Bank of Los Angeles had a valid, perfected lien on all the rents, issues and profits arising from the properties subject to their deed of trust long prior to the accrual of the income taxes for which the United States seeks payment out of the bank's security. Not only did it have a valid and perfected lien, it had a contract of sequestration, by the terms of which no part of this income except such as was voluntarily released ever became a part of the assets of the bankrupt estate. All of these rents, issues and profits were by agreement *to be paid over in full to the bank.*

The bank gave up its rights valued at hundreds of thousands of dollars as consideration for this agreement to sequester and *pay over in full* these rents, issues and profits.

The Trustee in Bankruptcy was not required to operate the bankrupt's business. He could at any time have handed the property over for foreclosure to the bank. He elected to operate the business of the bankrupt, not for the secured creditor, whose liens were no part of the estate, but for the benefit of the unsecured creditors whose debts he wished to pay. He knew when he elected to operate this property that none of the income could be used to pay his debts and expenses, including taxes (except state and county taxes) incurred by him, for he had

himself agreed, with the approval of this court, that all of such income was payable to the bank on its lien.

The fact that the bank received the royalties from the Universal lease to apply on its debt, for which they were expressly pledged prior to incurring the income tax claims, does not in any wise alter the picture. The collection of these sequestered royalties by the trustee puts them in no different category than the collection of rentals from a building, except that the royalties waste a part of the corpus of the property.

There is no difference between the lien on the property and the lien on the royalties. There was a valid, perfected lien on both and the trustee was bound to pay over in full both the proceeds from the sale of any land and any rents, issues and profits from any pledged property. Also remember that the trustee, with the approval of the court, had a valid agreement to collect these rents and pay them over in full to the bank, the consideration for such services being paid by the bank and received by the trustee in advance. If the trustee is now to be allowed to break his agreement and have his expenses paid out of the property pledged to the bank, it would appear that the bank's debt should be augmented by the amount it paid for such services, a sum in excess of $300,000.00. The trustee should not be allowed to keep the consideration received and refuse to render the service agreed upon in the terms of the contract. After all this is a court of equity.

At this point the other case should be cited—it fits in at this point. It is

> *United States Fidelity and Guaranty Co., plaintiff, v. Triborough Bridge Authority and Joseph D. McGoldrick, defendants, and United States of America, intervenor* (Supreme Court, N. Y. County, Special Term: Part III, March 31, 1944, No. 4515, 1943; Special Term 3, March 14, 1944).

The facts of the case were as follows:

The action was instituted by plaintiff to recover the sum of $55,611.00 out of a fund of $108,904 held by defendant. The fund represented a final payment to Petracca & Banks Inc. under a construction contract with Triborough. The United States intervened and claimed the entire fund under a tax lien in aid of which a Notice of Levy was served June 6, 1942. The plaintiff was surety on the construction contract. Plaintiff was compelled to pay $55,611.00 to certain contractors for labor and materials. These payments were made after notice of assessment and demand by the United States on Petracca & Banks Inc. Under the contract of surety the plaintiff had a right of subrogation to any money due the contractors if it were called upon to pay the obligation of the contractor under its contract. Having been compelled to pay certain of the contractors, it sought repayment out of funds due under the contract. The United States Government sought to step in and take all of these funds on the assessment of a tax lien against the contractor.

The court said:

> "To permit the intervenor to come in at a later date and assess a tax lien for a period which includes a year prior to the making of the contract would be inequitable and improper as a matter of law. (Prairie State Bank v. United States, 164 U. S. 227; Scarsdale National Bank v. U. S. Fidelity & Guaranty Co., 264 N. Y. 159.) Furthermore, pursuant to Section 3670 of the Internal Revenue Code, the intervenor has *only a lien upon the property and rights of the taxpayer.* In the instant case, the taxpayer's rights were *subordinate to those of the plaintiff,* and the right of the plaintiff, and the rights of the intervenor cannot rise any higher than those of the taxpayer. To permit the intervenor to have priority over the plaintiff would conflict with *common sense and good business usage and would be opposed to sound public policy which recognizes the validity of contract.*" (Emphasis added.)

This case is strikingly analogous to the case at bar. In the above case the plaintiff had a valid right of subrogation, a lien if you please, on the proceeds from the contractor's contract to repay it for money advanced for the contractor's benefit. The Government tried to invade the fund on which the plaintiff had its lien, to pay the income taxes assessed against the contractors who earned the fund.

In the case at bar the Government is trying to invade the fund pledged to the bank as security for money advanced the bankrupt and a large sum advanced the

Trustee in Bankruptcy to acquire the very property from which the oil was produced.

The claim of the Government for income taxes incurred by the Trustee in Bankruptcy cannot be given priority in the funds of the Newport Estate any more than the claim for such taxes against the contractor could be given priority against the fund in the above case.

In either case, to give such priority would be "opposed to a sound public policy which recognizes the validity of contracts," to use the language of the court in the above cited case.

We desire to direct the court's attention to Section 64a, Subdivision 4 of the Bankruptcy Act, as follows:

> *"Section 64.* Debts Which Have a Priority—a. The debts to have a priority, *in advance of the payment of dividends to creditors* and to be paid in full out of bankrupt estate, and the order of payment shall be . . .
>
> (4) Taxes legally due and owing by the bankrupt to the United States or any state or subdivision thereof; Provided, that *no order shall* be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court:
>
> And provided, further, that, in case any question arises as to the amount or legality of any taxes, such question shall be heard and determined by the court."

Quoting the words of Prentice-Hall Bankruptcy Service annotating said Section 64:

> "Section 64 gives the rule for paying out the money arising from the bankrupt's property which *remains* for general distribution after all special liens and encumbrances have been dealt with."

Even as to the general assets of the bankruptcy estate, taxes due the United States Government take fourth place and this court would not be warranted in paying said taxes prior to the three general classifications granted priority over them.

Even then the statute forbids the payment of these taxes where they are in excess of the value of the interest of the estate in said properties.

In the case at bar it is, we submit, clear that there is no equity in the property for the trustee and the creditors over the bank's lien.

Certainly, the United States Government did not show any such equity over the bank's lien in support of its petition.

As was said in the case of

In re Tressler, 20 F. (2d) 663:

> "The 'Bankrupt Estate' consists of property of a bankrupt diminished by valid liens."

This case, as well as the previous cases, demonstrates that such sequestration contracts by which the trustee collects rents and pays them over forthwith in full are quite ordinary and uniformly upheld by the courts.

The Contract of January 12, 1937, as Supplemented and Modified and Approved by the Court, Does Not Provide That Oil and Gas Royalties Can Be Used to Pay Income Taxes.

Under the heading of "Disbursement of the Special Fund" the contract provides:

> "Out of the Special Fund, the *Bank* shall pay all taxes, assessments, insurance, interest and other charges and expenses of trust D 7224, and not theretofore paid by the Trustee in Bankruptcy." [Tr. p. 109.]

This language limits the use of funds in the special account to payment of taxes, a charge on Trust D 7224. The only taxes a charge on Trust D 7224 were state and county taxes, a lien on the property held by the bank in said trust. Expenses of administration of the Trustee in Bankruptcy for his income taxes certainly were no charge on Trust D 7224 of which the bank is sole trustee. Under the heading "Oil Income and Its Distribution," the contract provides:

> "All income from oil, in the nature of bonuses, rentals or royalties for, or from any oil lease thereon shall be collected by the bank, and shall in no event be paid over to, or collected by said Trustee in Bankruptcy." "The funds in said account shall be available to the Trustee in Bankruptcy for the purpose of making up any deficiency in the 'Special Fund' to pay interest, taxes, assessments and expenses as hereinabove provided, in order to obviate a default; provided, however, that all sums taken from the Oil Account for such purpose shall be repaid to said Oil Account from moneys thereafter coming into the

> Special Fund, and not needed to pay other or additional interest, taxes, assessments or expenses then due."

The use of money in the Oil Account is expressly limited to the making up of any deficiency in the Special Fund as above provided. As above provided, the funds in the Special Account are limited to the payment of expenses, including taxes, a charge against Trust D 7224.

To hold that the contract provides for the payment of administration expenses of the Trustee in Bankruptcy which are no charge against Trust No. D 7224, or the bank as its trustee, is to distort the plain language of this contract. Please bear in mind that when this contract was supplemented and modified to permit the Trustee in Bankruptcy to collect the income, it was the express condition that all of the funds should be paid over to the bank forthwith *in full* and that while in the trustee's hands they were impressed with the bank's lien and were to be no part of the bankrupt estate.

Mr. Harpole, counsel for the United States Government, on the hearing of the Government's Petition, expressly disclaimed making the claim that the contract of January 12, 1937, authorized such payment. [Tr. p. 289.] The attorney for the Trustee in Bankruptcy in his answer to the Petition for Payment of Taxes, the basis of this suit, alleged:

> "That the income taxes due United States of America for the years 1938 and 1939 are not entitled to priority over any other expense of adminis-

> tration of this estate. That if United States of America is entitled to have its claim for royalties heretofore mentioned, then other expenses of administration should be paid out of the same funds on equal parity with said claim." [Tr. p. 99, par. VIII.]

Hence we see that not only does the Government claim expenses of administration, to-wit, income taxes, but the Trustee in Bankruptcy expects to ride in on the Government's coat tails to claim all the expenses of administration to be prior to the bank's claim in these rents and royalties hypothecated to the bank and sequestered for its benefit.

To allow such a spoliation of the secured creditor, we submit, would shock the conscience of the Chancellor.

The Trustee in Bankruptcy in Collecting These Sequestered Rents and Royalties From Property the Title to Which Was Held by the Bank as Trustee of Trust D 7224, Was Not Preserving the Assets of the Bankrupt Estate as That Term Is Used by the Courts.

The oil royalties collected by the Trustee in Bankruptcy from Universal Consolidated Oil Co., the lessee of the 9-acre Long Beach Harbor Lease, fall into no different category than the collection of rentals for agricultural lands of the bankrupt.

In the case of

Callahan v. Martin, 3 Cal. (2d) 110 at 123 (6),

the court says:

> "The royalty return which the lessee rendered to his lessor for this estate in the land is rent, or so closely analogous to rent as to partake of the incidents thereof."

In

Elsinore Oil Co. v. Signal Hill Oil Co., 3 Cal. App. (2d) 570 at 573,

the court says:

> "In mining leases the words rents and royalty are used interchangeably to convey the same meaning."

The collection of these rents and royalties cannot be termed preservation of assets as that term is used in equity. Nor was any such distinction made by this Honorable Court in its decision assessing income taxes against the Trustee in Bankruptcy.

Nor did the Trustee in Bankruptcy do anything or incur any expenses in preserving either the land of the oil lease or the oil thereunder. The lessee did all the work of preserving the oil under this property and paid a good rental for doing so. The trustee incurred no expense in obtaining the oil. He simply collected the rentals for the bank, as he had agreed to do by contract. The rentals were sequestered long before their production, to be turned over to the bank in full. Of course, the general unsecured creditors got the benefit of these rentals and royalties for they were applied in the reduction of the bank's secured indebtedness.

These income taxes incurred by the Trustee in Bankruptcy were only an expense of administration and such expenses of administration have never been held to be expenses in preserving assets of the estate.

Mr. Harpole, the Government's counsel, expressly states that:

> "The claim of the Government is here as an expense of administration in this bankruptcy case." [Tr. p. 251, par. I.]

And again:

> "As I pointed out a minute ago this is an expense of administration." [Tr. p. 253.]

And again:

> "I am just interested in an order directing that payment of administration expenses, particularly that the Federal income tax be paid."

Opposing counsel was quite correct in calling these taxes administration expense.

Section 64 of the Bankruptcy Act lists debts having priority of payment out of general assets of the bankrupt estate. (*U. S. Code,* Title 11, Ch. 7, Sec. 104.)

This section gives priority out of general assets of the bankrupt estate:

First, to the actual and necessary costs of preserving the estate subsequent to filing of the petition.

Second, to the filing fees of creditors in involuntary cases;

Third, to costs of recovering property reserved for the benefit of the estate of the bankrupt by creditors;

Fourth, the costs and expenses of administration.

Taxes incurred by the Trustee in Bankruptcy have uniformly been held to be merely expenses of administration as contrasted with expense of preserving assets, etc.

See Collier on Bankruptcy 14th Ed. page 2074.

Matter of Lambertville Rubber Co. Inc., C. C. A. 3rd (1940), 111 Fed. (2d) 45;

In re Clark Coal & Coke Co., 23 Am. Br. Rep. 273;

The case of Hanson v. Birch, Vol. 1. Am. Br. Rep. (N. S.) 549 at 551;

says:

"A bankruptcy proceeding is for the administration and not the dissipation of the estate. It is undertaken primarily for the benefit of general creditors, and they in general control it . . . It may, in this case, have been reasonable and necessary to store the stock and soda fountain in the rented store until the trustee took charge and until the stock was sold, but the retention of the store for months thereafter cannot well be justified. So the reduction of the property to cash and the foreclosure of the lien resulted in benefit to the lienor, but only to the extent that it saved him the expense necessarily incident to a foreclosure in this or any other court. Where, as here, the lienor does not seek the aid of the bankruptcy court, but is proceeded against in invitum, he is, aside from the cost of preserving the property, just dealt with, chargeable with no costs of administration beyond the benefit to him measured by this necessary cost of foreclosure. *Gugal v. New Orleans Nat. Bank,* (C. C. A. 5th Cir.) 29 Am. Br. Rep. 160, 239 Fed. 676. No doubt can be had of the jurisdiction of the bankruptcy court to administer property found in the possession of the bankrupt and to adjudicate claims to and liens upon it as a part of the bankruptcy proceeding.

> Collier on Bankruptcy, 12th Ed. p. 541. . . . Here it was the trustee who, instead of relinquishing the property to the lienor as burdensome to the estate, decided to contest the lien . . . He and those he represents must bear the cost of the error."

In the case at bar, liquidation was the purpose of the contract of January 12, 1937. If the Trustee elected not to abandon the property, but to operate a business, he must pay all the expenses without resort to incomes and property sequestered to pay the secured creditor's debt.

> *In re Williams,* 159 Fed. 934 at 939, (Ninth Circuit), quoted from *supra.*

In the case at bar the fund from which the court has ordered these income taxes paid is no part of the bankrupt estate. The same court that now makes the order to pay taxes out of these funds from oil royalties approved the agreement heartily ten years ago and agreed to the provision that the funds were no part of the assets of the bankruptcy estate and were to be paid over in full to the bank. We submit that the positions then and now are utterly inconsistent.

This court will recall that the bank gave up rights under its Trust Deed of a value in excess of a quarter of a million dollars to obtain a liquidating contract and an unambiguous covenant sequestering all of these funds for its benefit.

This court is a court of equity, and the repudiation of the contract ten years after it was made will not be looked upon favorably, we are sure.

The Finding That the Income Tax for the Calendar Years 1938 and 1939 Was the Result of Income, the Full Benefit and Enjoyment of Which Was Had by Security-First National Bank of Los Angeles, Is Quite Unwarranted.

After all, the Contract of January 12, 1937, as supplemented and modified, was proposed by the Trustee to obtain a postponement and orderly liquidation of the property held by the bank in its Trust. This was for the benefit of the unsecured creditors. When the oil income was developed the payment thereof to the bank to apply on its indebtedness reduced the claim of the bank which had to be paid in full before the General Creditors could get anything. Every dollar collected and paid to the bank has been in reduction of legitimate secured obligations with resultant advantage to the Bankrupt Estate, and the unsecured creditors. It is for their benefit the Trustee in Bankruptcy has been working. It was for their benefit he conducted the business which gave rise to the income taxes in question. There is no logic to the claim that he should be permitted to pay his debts and expenses out of the bank's funds. At any time he could have surrendered up and abandoned the property to the bank. He elected to operate it. The taxes incurred should be paid only out of the general assets of the Bankrupt Estate of which the funds in question are no part.

We respectfully submit that we have shown that the Security-First National Bank of Los Angeles holds a first and prior lien on all rents, royalties, issues and profits, aris-

ing from the property held by it in its Trust D 7224, and that a valid contract with the trustee in bankruptcy was entered into in 1937 sequestering these funds for the bank. That by this contract, the funds became no part of the bankrupt estate and were to be paid over in full, to the bank by said trustee in bankruptcy upon receipt by him. And that while in his possession they were to be kept segregated and were earmarked for payment over to the bank.

We submit that we have shown that as to these funds the Bank was in constructive possession thereof and deemed in law to be the equitable owner thereof.

We submit we have shown that the bank agreed only to liquidation and not to the operation of the business of the bankrupt. And that if the Trustee in Bankruptcy elects to operate such a business the cost of administering such business falls on him and not on the secured creditor. That income taxes are an expense of administering the Bankrupt Estate and never are considered as expenses incurred in preserving the Bankrupt Estate.

That in operating the bankrupt's business the Trustee was working for the benefit of the unsecured creditors and any expense incurred by him therein, including income taxes, must be paid from the general assets of the Bankrupt Estate.

We submit we have shown that to take the bank's property to pay an unsecured creditor's debt, violates the state and federal Constitutions, violates the contract of January 12, 1937 as supplemented and amended and approved by

this court, and, as this court once said, such a remedy would be "harsh and unequitable."

We pray that the order appealed from be reversed and that the said Bankruptcy Court be ordered to enter its order directing the Trustee in Bankruptcy to pay over these funds in full to the bank for application on its indebtedness.

Respectfully submitted,

W. C. SHELTON and
GEORGE W. BURCH, JR.,
By W. C. SHELTON,
Attorneys for Appellant.